Basic Insurance Principles

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Learning Outcomes

- Explain the meaning of the following terms:
    i. Indemnity
    ii. Utmost good faith
    iii. Insurable interest
    iv. Subrogation
- Define the term betterment and provide two examples of where this may be applied to a claim for vehicle repairs following an insured loss.
- Describe a scenario where the policyholder might receive less than indemnity in settlement of an insured loss.
- Explain the purpose of the Consumer Insurance (Disclosure and Representation) Act 2012 and the redress available to insurers in the event that their policyholder misrepresents material facts.
- Explain how the Insurance Act 2015 amends the application of the principle of utmost good faith within commercial insurance.

Overview

To understand the principles of insurance practice which apply to motor insurance.

Many of the basic principles of insurance are based in common law.

Common law refers to the law developed through decisions of courts or similar tribunals, rather than through legislation that has been passed through parliament (Act of parliament). Common law is effectively the unwritten law of the land.

The foundation of the common law system is the principal of judicial precedent.

Section 1: Indemnity

The definition of indemnity is:

"Financial compensation sufficient to place the Insured in the same position after a loss as they enjoyed immediately before the loss happened"

The Insured must not be in a better position than before the loss, they must not benefit from the loss happening.

The principal was established in the following case:

Castellain v Preston 1883. The seller of a house recovered £330 from his insurer when the property was damaged by fire between the signing of the contract and the completion of the sale. The buyer afterwards completed the purchase and despite the fire, paid the full asking price of £3100. The seller was ordered to pay the £330 back to his Insurers as otherwise he would profit from the loss.

How might a policyholder benefit from a repair carried out after an insured accident?

There are occasions where existing damage (a previous accident or wear and tear) has been exacerbated in the accident and by repairing the accident damage the existing damage will be rectified as well.

Betterment

Betterment describes the increase in vehicle's market value that may occur following a repair. Betterment typically happens where parts are replaced that have a limited life expectancy, for example tyres or exhaust. Where betterment happens an insurer may request a financial contribution from the Insured to reflect the fact that the repair has increased the value of the vehicle'

Examples.

- A brand new tyre replaces one that is 50% worn. Although for the individual part there is at least a 50% increase in the value, any increase in the market value of vehicle is insignificant.
- Completely repainting a vehicle that is several years old will increase the market value and therefore requesting a contribution can be considered.

There are also occasion where a policyholder may receive less than indemnity in settlement of a loss. These situations usually arise due to a policy condition or limit, examples of this include audio equipment which may have a limit applied if none standard equipment is fitted. The policy limit for none standard audio equipment may be £250, this is the maximum payment possible irrespective of the actual value of the equipment.

Agreed value policies.

Agreed value policies provide for settlement of an insured loss that is not on an indemnity basis. These policies are often available for classic or cherished vehicles where the value of the vehicle is agreed at the point of policy inception, often an engineer's report confirming the value will be required. Where a policy is underwritten on an agreed value basis, in the event the insured vehicle is not considered a repairable proposition following an insured loss/accident, the policyholder will receive the value agreed at inception and this could be above or below the actual market value at the time of loss.

Section 2: Utmost Good Faith

Insurance contracts are subject to the principle of **'uberrimae fides'** or 'utmost good faith'. Both parties are required to disclose fully and accurately all material facts relating to the risk, which are known or which ought to be known to them.

The requirement is a positive duty, this refers to the requirement to voluntarily provide information which is material and not limited to providing information if requested.

This differs from general contract law where the principal of caveat emptor (buyer beware) applies, this requires both parties in the contract to answer truthfully and does not extend to volunteering facts material to the contract. For example in a private sale of a car, if the seller is asked about the service history by a potential purchaser the seller must answer truthfully, however, if the question of the service history is not raised the seller is under no duty to voluntarily disclose this information.

A fact is considered to be material if it is one which would influence a prudent underwriter in his judgement of the risk. This means that the information about the subject matter of the risk is a fact which would affect the premium, terms of the policy or acceptance of the risk.

The following are examples of information that would typically be considered to be material facts in motor insurance:

- make and model of vehicle,
- modifications,
- annual mileage,
- claims history,
- criminal and driving convictions,
- occupation,
- use of vehicle,
- age and licence type.

There are many more examples of facts material to a motor insurance risk and the specific information will vary between Insurers. Since December 2011 the EU ruling on gender-neutral pricing in insurance has prevented insurers from using gender as a rating factor, therefore whether the driver is male or female will not affect the premium and is not a material fact.

A breach of the principal of ubberimae fides/utmost good faith provides the innocent party with the right to void the contract. In the event that the policyholder fails to disclose a material fact the Insurer has the right to not only refuse indemnity for any loss, they are also able to void the policy from inception. Similarly if the Insurer fails to disclose a fact which is material to the cover provided the Insured has the right to request the contract is void and the premium returned in full.

Whist the principal of utmost good faith still exists, two pieces of legislation have been introduced which amend how non-disclosure is dealt with in both private and commercial insurance.

<u>Consumer Insurance (Disclosure and Representation) Act 2012</u>

The act only applies to “consumer” Insurance, within the act consumer insurance is defined as insurance for purposes unrelated to the individuals trade or business.

The purpose of the act is to reduce the burden place on consumers during the insurance contract negotiations by replacing the positive duty to disclose material facts with a duty on the underwriter to ask questions of the consumer. The principal of utmost good faith was replaced with a duty on the consumer to take reasonable care not to misrepresent material facts, a consumer’s duty is now only to ensure they answer all questions asked of them honestly.

The act also restricts the rights available to insurers in the event that a policyholder misrepresents a material fact. The rights are summarised below:

Nature of misrepresentation	Redress available to insurer
Innocent misrepresentation	No redress available to the Insurer. The claim and policy are not affected.
Careless misrepresentation **(it was not deliberate or reckless)**	The redress is dependent on the severity of the misrepresentation: • If the Insurer would not have entered into a contract had the true facts been known, the policy may be void and the premium returned. • If the policy would have been entered into under different terms, the policy can be treated as if these terms applied. • If the Insured would have charged an additional premium, the claim settlement can be reduced proportionally.
Deliberate/Reckless misrepresentation. **(The consumer was aware the statement was untrue and disregarded the consequences)**	The Insured may void the contract and in the event that fraud is confirmed, the premium may be retained.

Insurance Act 2015

The Insurance Act 2015 was introduced from August 2015 and extends the reforms made to consumer insurance by the Consumer Insurance (Disclosure and Representation) Act 2012 into commercial insurance.

The Insurance Act 2015 has wider consequences than misrepresentation, for the purposes of these studies only the amendment of the principal of utmost good faith will be reviewed.

The act only applies to non-consumer insurance (in connection with trade or business) and unlike in consumer insurance, the positive (voluntary) duty to disclose material facts is retained. The duty placed on a commercial customer is to make a fair presentation of the risk.

The duty to make a “fair presentation” is defined as:

- The customer must disclose to Insurers every material fact which the customer knows or ought to know.
- The customer must provide the insurer with sufficient information to put a prudent insurer on notice that it needs to make further enquiries.

The act will force insurers to become more involved in the assessment of a risk rather than relying on information provided by the insured or their broker/representative.

Similar to the Consumer Insurance Act, the Insurance Act provides details of the remedies available to an insurer.

Nature of misrepresentation	Redress available to insurer
Innocent or negligent misrepresentation	Only proportional remedies are available, the Insurer has no right to void the contract. The Insurer must deal with the claim as they would have done had they known the true facts at the time of inception. For example apply a policy condition or reduce a claims settlement in proportion to the additional premium.
Deliberate or Careless misrepresentation	The Insurer is only entitled to void a policy if the breach of “fair presentation” is deliberate or reckless and the Insurer would not have offered cover had the true facts been known. In these circumstances the Insurer may also retain the premium.

Section 3: Insurable Interest

Insurable interest is necessary to create a valid insurance contract. Insurable interest is defined as:

"The legal right to insure arising out of a financial relationship recognised at law between the Insured and the subject matter of the insurance.

Why does the law require insurance interest for an insurance policy to be valid? Consider the possible consequences of allowing life insurance policies to be sold without insurable interest

The presence of insurable interest is the main difference between an insurance policy and a wager. The absence of insurable interest may cause the insured to take less care of the subject matter or to deliberately cause a loss in order to collect the insurance money. This behaviour is undesirable in personal lines insurance such as motor, household and travel insurance, in life insurance the requirement for insurable interests prevents an individual taking out a life policy on a stranger who is known to be in poor health purely to gain financially upon their death.

The difference between Insurance and Wagers

Insurance contract 	**Wager** 
Financial interest in the subject matter required	Interest is limited to the stake to be won or lost
The purpose of the contract is to protect the Insured against a known loss	Each party can win or lose, the loser is not known until after the event
Full disclosure is required by both parties	Full disclosure is not required by either party
In most cases the payment made reflects the loss suffered	The payment is made to the winner without a loss being suffered
The contract is enforceable by law	Neither party can enforce the contract in court.

The main components of insurable interest are as follows:

- Economic or financial interest. The insured must suffer a financially measurable loss if the insured event happens.
- Legal relationship with the subject matter. In motor insurance this could be that you are the owner to the vehicle, or that the vehicle is in your possession/safe keeping (repairer).

Who has an insurable interest in a hire purchase vehicle?

Both the hirer and the hire purchase company, the hire purchase company's interest is limited to the amount of finance outstanding.

When must insurable interest exist in motor insurance?

At the time of the quotation	No. Insurable interest is not required before the policy is live.
At inception	Yes. A policy is not valid if there is no insurable interest at the time the policy goes live (inception).
At the time of the claim	Yes. A claims payment cannot be made if there is no insurable interest.

Insurable interest in motor insurance must exist both at **inception** of the policy and at the **time of the claim.**

Section 4: Subrogation

The Common Law principle of subrogation is the corollary of the principle of indemnity in that it prevents the insured from recovering more than the loss suffered. Subrogation prevents the Insured from recovering from the same loss twice.

Subrogation is defined as:

"The right of one person, having indemnified another under a legal obligation to do so, to stand in the place of that other and avail himself of all rights and remedies of the other, whether already enforced or not"

In the case of Castellain v Preston 1883 what would the position have been if the court had not enforced the repayment of the repair costs to the Insurer?

In this scenario the sale of the house went through without a deduction in the agreed price. This price was agreed before the fire damage. If the seller of the house had been able to recover the cost of the repairs from the Insurer and they also received the full pre-loss market value of the property they would have gained financially from the claim/fire.

An insurer can avail themselves of any rights that their insured has to recover any amount from another person who may be responsible for the accident/loss.

In other words, the insurer has the right to stand in the shoes of their insured to recover the claim costs from the responsible third party.

The right of subrogation at Common Law can only be exercised after the insurer has settled their policyholder's claim. This can disadvantage the Insurer as they are unable to take control of the recovery of their outlay from the date of the loss. To amend this situation most motor insurance policies, have a policy condition stating that the Insurer will take over control of the recovery against negligent party as soon as the claim is notified.